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SUBJECT: NO SUB-PRIME CRISIS HERE: CONSTRAINTS ON  
COMMERCIAL LENDING IN IRAQ

¶1. (SBU) Summary: The GOI wants the Central Bank of Iraq (CBI) to loosen its monetary policy to promote economic growth. But cuts in the CBI's interest rates or reserve requirements will not deliver the growth boost GOI officials seem to expect. Iraqi banks already have plenty of money to lend, so expanding the money supply will not mean more loans for businesses and households. Iraqi banks lack the credit infrastructure needed for lending that expands output and creates jobs. Rather than press the CBI to print more money, the GOI should take steps to build a money market that gives banks tools to measure and manage risks. End summary.

Leaning on the CBI

¶2. (SBU) Senior CBI officials report in private that the GOI is exerting "intense pressure" for changes in monetary policy. It is a commonly held view in Iraq that banks do not lend because the CBI sets interest rates too high and requires state-owned banks to hold unusually high levels of reserves. GOI ministers have reportedly threatened to revoke the CBI's statutory independence if it did not loosen monetary policy. Partly as a result of such pressure, the CBI cut its policy rate from 20 percent to 16 percent over the first half of the year.

¶3. (U) When GOI leaders look to the CBI to facilitate lending, they may be thinking of how Iraq's economy used to be organized. When state-owned enterprises, government plans, and international sanctions defined Iraq's economy, the central bank served as little more than a cash dispenser. Price stability was not in its mission statement. From 1993 through 2002, Iraq's average annual rate of inflation exceeded 100 percent.

¶4. (U) Iraq is building a new economy, but a good deal of the old machinery remains in place. The GOI payroll still accounts for the bulk of salaried employment. Vestiges of controlled prices, intra-enterprise barter, and the planning apparatus still cause significant economic distortions. Habits learned in the bad old days still guide the economic policy instincts of leading politicians and senior bureaucrats.

A Banking System Awash in Money

¶5. (U) Iraq's financial plumbing, however, is brand new. Risk management and profit maximization now drive bank lending, not orders from the top. As a result of decades of directed lending, most of the state-owned banks carry a crushing burden of non-performing assets. The two largest banks, Rafidain and Rashid, are technically insolvent and unable to take on new risks. Over the past year, the loan portfolio of state-owned banks grew by less than 10 percent, mainly through non-commercial, GOI-subsidized programs. Over the same period, lending by private banks grew by nearly 50 percent.

¶6. (U) The role of the central bank is also radically new. The CBI takes seriously its statutory responsibility to

achieve price stability. And it has performed admirably on that score under extremely difficult conditions. The CBI's most effective policy tool is intervention in the foreign-exchange market. By auctioning dollars at ever lower prices, the CBI takes a large volume of dinars out of circulation, restraining growth of the money supply. The increasing value of the dinar also makes imported goods more affordable, further blunting inflationary pressures. Iraq's core price level (excluding volatile food and fuel components) is now increasing at an annual rate of between 10 and 15 percent, less than half as fast as in 2006.

17. (U) Even though the CBI has curbed inflation through a restrictive monetary policy, the banks have more than enough money to support more commercial lending activities. In addition to cash reserves mandated by CBI regulations, all banks in Iraq maintain remarkably high levels of excess reserves, on which they earn no financial return. On average, Iraqi banks hold excess reserves equivalent to about 6 percent of total assets, a ratio more than 10 times higher than in the developed world. This holds even for the private banks, which lend far more actively than the moribund state-owned banks.

#### Infrastructure, Not Interest Rates

18. (U) With so much liquidity available, banks need not borrow to fund new loans. Some observers note that banks earn interest on their deposits with the CBI, so the high policy rate gives them a riskless investment alternative that discourages lending. But the CBI enforces a limit on banks' access to its interest-bearing deposit facility. Funds in

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excess of this limit remain with the banks as idle balances, immediately available to fund new loans. Under these conditions, cuts in the CBI's policy rate or required reserve ratios have no effect on the supply of credit.

19. (U) So if Iraqi banks have money, why don't they lend more of it? The answer lies in the first rule of banking: Don't lend money you don't expect to be repaid. Under present conditions, the supply of loanable funds in the banking system exceeds the supply of acceptable lending risks. Meanwhile, banks earn reasonable profits from no-risk services like currency exchange, letters of credit, and performance guarantees. As the private banks grow and competition intensifies, the fee-for-service model will become less profitable and banks will put more emphasis on lending.

110. (U) How quickly the banking system makes the transition to profitable intermediation depends on the development of financial infrastructure Iraq still lacks. In order to deploy their excess reserves profitably, Iraqi banks must be able to measure and compare the risks of alternative lending opportunities. They need to be able to enforce claims on collateral. And they need a money market where banks and businesses trade financial claims for cash. To promote growth, the GOI should work to build the financial infrastructure that provides these capabilities, not lean on the CBI to loosen monetary policy.

#### What the USG is Doing

111. (U) USG programs already bridge some gaps in Iraq's financial infrastructure, at least on a small scale. Lending programs supported by USAID provide modest financing where banks fear to tread, mainly for small enterprises. For larger enterprises, OPIC has made financing available through the Iraq Middle Market Development Foundation. Treasury and Defense have introduced electronic funds transfer to the banking system, significantly lowering transaction costs. At the local level, Provincial Reconstruction Teams work with small businesses to develop entrepreneurial skills, design business plans, and locate sources of financing. These

initiatives help move Iraq's economy forward by reducing the costs and risks associated with lending.  
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